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73d Congress, 1st Session } HOUSE OF REPRESENTATIVES { Report No. 207

AMEND THE BANKRUPTCY ACT—MUNICIPAL INDEBTEDNESS

JUNE 7, 1933.—Referred to the House Calendar and ordered to be printed

Mr. SUMNERS of Texas, from the Committee on the Judiciary, submitted the following

REPORT

[To accompany H.R. 5950]

The Committee on the Judiciary, to whom was referred the bill (H.R. 5990) to amend the Bankruptcy Act, as amended and supplemented, after consideration, reports the same favorably to the House with the recommendation that the bill do pass.

The controlling purposes of the bill is to provide a forum where distressed cities, counties, and minor political subdivisions, designated in the bill as "taxing districts", of their own volition, free from all coercion, may meet with their creditors under the necessary judicial control and assistance in an effort to effect an adjustment of their financial matters upon a plan deemed mutually advantageous. If a plan is agreed upon by the taxing district and its creditors holding two thirds in amount of the claims of each class of indebtedness, and if the court is satisfied that the plan is workable and equitable, it may confirm the plan, and the minority creditors are bound thereby.

The general plan of this bill, as may be seen from the foregoing, is substantially that of the bills amendatory of the Bankruptcy Act dealing with railroads and dealing with corporations, which have been approved by the House.

THE CONSTITUTIONAL POWERS AND DUTIES OF CONGRESS.

The following quotation is taken from an opinion given by the Attorney General April 21, 1933:

> Approaching the question whether Congress may enact any form of bankruptcy legislation applicable to municipalities, it should be borne in mind that Congress alone can effectively act. The Constitution prohibits the States from enacting any law "impairing the obligation of contracts", and this prohibition covers a law discharging insolvent debtors from liabilities incurred prior to its passage. (*Sturges* v. *Crowninshield*, 4 Wheat. 122.)

The committee concurs in this opinion, and is convinced that because of this limitation upon the power of the States contained in the Federal Constitution the States do not possess the power necessary effectively to deal with the situation which exists with regard to bankrupt taxing districts.

In the hearings before the committee it was disclosed that as of date March 25, 1933, there were scattered among 41 States, 895 cities, counties, taxing districts, etc., designated in this bill as "taxing districts," which were in actual default with the number now well above 1,000, with many others threatened with default.

The committee is also convinced that a large majority of holders of the obligations of these taxing districts desire the enactment of this proposed legislation.

The committee has also taken into consideration, and regards of great importance, the public necessity of making it possible for cities, by mutual and effective agreement with their creditors, so to adjust their existing indebtedness as to carry forward without too hurtful a diminution the discharge of their governmental duties of fire, police, and sanitary protection, and education, and meet the increased burden incident to caring for those who must seek public assistance in order to live.

THIS BILL DOES NOT EXTEND THE FEDERAL JURISDICTION OVER THE STATES OR OVER ANY OF THEIR SUBDIVISIONS

These defaulting taxing districts may now be sued by nonresidents in Federal courts as a private person may be sued for debt, and by mandamus may be compelled to levy the necessary tax to meet past due obligations, and their officers may be sent to jail for contempt if they refuse to proceed to the levy and collection of the necessary taxes.

This bill would suspend the exercise of that Federal power during the reasonable time provided by the bill while a new plan possible of being carried out is in process of formulation.

This bill does not permit a taxing district to be forced into court. Only upon its own initiative and petition can a taxing district become subject to the jurisdiction of the bankruptcy court under this bill.

The bill is not only temporary, made so by a specific limitation of 2 years, but it is also specifically provided that as soon as the final decree is entered in any case the Federal court before which the readjustment has been effected shall immediately cease all jurisdiction, leaving the parties to their present and ordinary remedies with reference to all matters connected with the plan which may later come into controversy. As a further limitation upon Federal power and in respect for the rights and responsibilities of the States, it is provided as follows:

(l) Nothing contained in this chapter shall be construed to limit or impair the power of any State to control by legislation or otherwise any political subdivision thereof in the exercise of its political or governmental powers, including expenditures therefor and including the power to require the approval by any governmental agency of the State of the filing of any petition hereunder and of any plan of readjustment, and whenever there shall exist or shall hereafter be created under the law of any State any agency of such State authorized to exercise supervision or control over the fiscal affairs of all or any political subdivisions thereof, and whenever such agency has assumed such supervision or control over

any political subdivision, then no petition of such political subdivision may be received hereunder unless accompanied by the written approval of such agency, and no plan of readjustment shall be put into temporary effect or finally confirmed without the written approval of such agency of such plans.

This bill insofar as its coercive features are concerned is directed solely against the nonconsenting minority holding out, often, for its pound of flesh against the judgment of two thirds of the other creditors and against a taxing district unable to pay according to the present terms of its existing indebtedness, and in a sense holding out against the court of bankruptcy charged by the terms of the bill that before it may approve it, the judge must hear objections to the plan and find that the plan is fair and equitable.

The mechanics of the bill are substantially those of the two amendments to the Bankruptcy Act which are familiar to the House and which have been approved by the House.

MINORITY VIEWS

This bill seeks to confer upon the United States courts of bankruptcy jurisdiction to grant relief from public debts to municipal corporations and other governmental and semigovernmental subdivisions of a State. This authority has never heretofore been granted in any of the several bankruptcy acts which have from time to time been enacted by Congress since the establishment of the Government under the Constitution. In fact it has always been supposed that the Congress was without power to include municipalities as subjects of bankruptcy legislation. In the Bankruptcy Act of 1898, which is the present law, they are specifically excluded.

It is now proposed to bring such agencies of the several State governments within the operation of the bankruptcy law under certain limited conditions. Only the municipality itself may initiate the petition and it must show that it is unable to meet its debts as they mature and that thirty percent in amount of all its creditors have agreed in writing to the filing of the petition and have signified their willingness to have a plan of adjustment submitted to the court for confirmation. The plan shall not be confirmed unless two thirds of each class of creditors affected by the plan shall have previously accepted the same in writing.

The jurisdiction is permissive and the right to invoke it strictly ex parte on the part of the municipality. The municipality may not invoke it if prohibited by State law.

It can be readily seen from the foregoing that the bill is novel in purpose and method. Probably because of this very novelty and the doubtful legality of the whole proposal the effective provisions of the bill are prefaced by a preamble in section 78 formally declaring the policy to be served by the Congress in enacting the legislation.

There are, therefore, two aspects of this legislation that ought to be carefully considered before approval is given. First, the question of the legality of the act itself; and, second, the question of the policy of such legislation. That is whether it is the part of wisdom and prudence to pursue such a policy, even granting it is within the constitutional power of Congress to do so.

LEGALITY

Municipal corporations have never been the subject of bankruptcy laws in this country and until the present time it has never been suggested in debates in Congress that they could be.

There have been many profound and exhaustive opinions by the Supreme Court and the inferior Federal courts on the nature and extent of the power of Congress under the bankruptcy clause of the Constitution but in none of them has it ever been so much as intimated that the scope of the power embraced municipal corporations and other governmental subdivisions of the States. It has long been an accepted proposition of constitutional law that the bankruptcy power does not extend that far though there is as yet no judicial declaration of the Supreme Court to that effect.

Congress ought not to resort to a strained construction of its power under the bankruptcy clause of the Constitution to interfere with governmental instrumentalities of the States. On the contrary, its

duty requires it to refrain from legislation of such character unless its authority to do so is clear and unquestioned. If Congress is held to have the power to enact legislation in the form here proposed, then by indirection it can invade the field of sovereignty heretofore thought to be reserved to the States.

This bill not only permits cities and other strictly municipal corporations to become the subjects of bankruptcy but goes far beyond this and includes "any other political subdivision of any State."

Even the Attorney General, in his otherwise favorable opinion on the so-called "Wilcox bill", H.R. 3083, expressly declared against such a broad power in the following words:

> It seems foreign to the conception of bankruptcy to extend its remedies and the jurisdiction of its courts to a purely governmental body. Historically, at least, bankruptcy legislation presented remedies and relief which the soveriegn granted to adjust the relations between creditor and debtor when private persons, individual or corporate, became insolvent. It was never supposed that the sovereign itself could adjust its own debts through the medium of the bankruptcy court. * * * In my opinion the Constitution did not mean to permit Congress, through the medium of bankruptcy laws, to break down the boundaries between Federal and State power even if the States gave their consent. It follows that, if the Constitution does not confer this power upon Congress, its lack of authority cannot be supplied by acquiescence of the States. The situation is entirely different where the Constitution itself provides that Congress can act only with State consent or that the States can act only if Congress consents. (See art. 1, sec. 10, clauses 2 and 3; art. IV, sec. 3, clause 1.) See page 179 of the hearings before the Committee on the Judiciary, on H.R. 3083.

In this same opinion, on page 178 of the hearings, the Attorney General makes a distinction between purely governmental agencies of the State and those agencies such as municipal corporations which have a proprietary as well as a governmental character. With reference to the latter he gives it as his opinion that they may be the subjects of bankruptcy legislation but only with the prior consent of the State. He says:

> I conclude that the authority of a municipality to file a petition under a Federal bankruptcy act must be derived from State law and that the mere fact that the State has not prohibited such action is not sufficient.

A careful reading of this entire opinion convinces us that the Attorney General recognized the inherent and insuperable obstacle to such legislation as is here proposed from the constitutional point of view, and has only with the greatest difficulty found constitutional warrant for it even when applied only to municipal corporations. In our view there is no authority to enact such legislation even for municipal corporations which have received the prior consent of the State in which they are incorporated.

Either Congress alone has the power to subject municipal corporations to the jurisdiction of the United States courts of bankruptcy or else the power does not exist. It does the greatest violence, it seems to us, to sound principles of constitutional law to say, as the Attorney General does, "the authority of a municipality to file a petition in the Federal bankruptcy court must be derived from State law." (Second paragraph, p. 178 of the hearings.)

We are of the opinion that it must derive from Congress exclusively or not at all. No other authority than that of Congress is contemplated to give full effect and vigor to this power, and were this not so, the uniformity of bankruptcy legislation would be made impos-

sible by the necessity of concurrent action of any one or all of the 48 legislatures of the several States.

To permit the States to decide in conjunction with Congress whether or not its municipal corporations shall be subject to a Federal bankruptcy act would, of course, allow the State to say that one class of its municipal corporations might avail themselves of the act and deny such privilege to another class. If it is once admitted that the State's consent is necessary to make the law effective then it follows that the State may fix limits to its permission and set up other conditions. The effect of all this could be and probably would be that in the 48 States there would be a wide diversity in the effect of the Federal bankruptcy law upon municipal corporations.

The more closely one examines this question the more clearly it appears that a municipal corporation, like other political subdivisions of a State, cannot be and should not be subject to the bankruptcy act. The Attorney General's opinion gives very clearly the reasons why the power of Congress to enact a bankruptcy law applicable to political subdivisions other than municipal corporations is not constitutional, and we think that the reasons there given apply with equal force to municipal corporations as well.

If it were possible to separate from a financial point of view the purely governmental operations and functions of a municipal corporation as distinguished from its proprietary functions and operations, there might be greater reason for considering municipal corporations a proper subject of bankruptcy legislation, but it must be evident to anyone that the proprietary and governmental functions of such a corporation are so inextricably bound up with each other in the actual conduct of the municipality's government and business that it is, for all practical purposes, impossible to separate them and administer them so that the bankruptcy court, would in a given case, know definitely and positively that it was not interfering in any way with purely governmental functions.

We conclude, in view of the foregoing, that there is, to say the least, the greatest doubt of the constitutionality of this bill, with reference to municipal corporations. We conclude, also, that as to all other political subdivisions, there is no authority whatever for Congress to subject them to the Federal bankruptcy jurisdiction, either alone or in conjunction with State enabling legislation. Therefore, we feel the bill should be rejected on its evident lack of constitutionality in this latter respect and its doubtful constitutionality as to municipal corporations.

POLICY OF THE LEGISLATION

Added to the doubtful legality of this legislation there is the equally serious question of the policy of enacting it at this time. Is it wise or prudent to attempt this admittedly novel experiment of throwing open the doors of the bankruptcy court to municipal corporations and other political subdivisions of the State? No one can now foresee the results that may follow such a radical departure from the long established practice of the past. The very novelty of the thing will adversely affect the municipal bond market. The credit of solvent cities will suffer along with those that are insolvent. The high standing of municipal bonds, as Government obligations founded upon the faith and credit of the Government, will certainly be impaired.

For years municipal bonds have been on a par with the bonds of the United States Government and State governments. In fact, New York City liens and the liens of other large cities in the country have enjoyed an even higher rating than the bonds of many of our States. This confidence on the part of the lending public is due to the fact that the taxing power assured their payment.

Investors know that with these securities there is no danger of loss of their principal, except by repudiation, and this has rarely happened. Cities have been very anxious to maintain the high character of their credit and have, therefore, in the past strained every effort to meet their obligations as they fell due. The overwhelming majority of municipalities today are striving in every way to meet their obligations, notwithstanding the heavy burden that it is placing upon their people.

There are a number of cities in the country that have not been able to pay the principal and interest on their bonds, but this is due, in most instances, to the extreme severity of the present depression and also to the peculiar boom conditions and circumstances under which some of these communities incurred debts out of all proportion to their ability to pay. It is because of the unfortunate predicament of these communities that the demand has arisen for this legislation.

While the passage of this bill may temporarily aid such communities, it will, in the long run, be detrimental to their credit standing and to that of every other municipality in the Nation. No longer will municipal bonds be rated as prime securities for trust funds as they are today. Today they form the financial backlog of insurance companies, fraternal benefit societies, mutual savings banks, college and hospital endowments, and other charitable and benevolent enterprises. To a very large extent these bonds may be said to furnish the main support of thousands and hundreds of thousands of widows, orphans, and retired elderly people. The principal of the bonds themselves represent the life savings of the thrifty middle class of the country.

To do anything that would in the slightest degree unsettle confidence in these securities would, indeed, be a most unwise act. Especially at this time does it seem most inopportune to pass any legislation that may result in a shrinkage of the market value of these bonds. The Congress has recently passed a series of bills which have for their express object and purpose the raising of the price level of commodities to at least 25 percent or more. It is believed that in the very near future these objects will be realized and, therefore, the fixed income of those who rely upon bonds for their livelihood will be reduced in precisely the same degree as the price level is increased. In other words, municipal bondholders, in addition to the loss which they will suffer by this bill, must face an almost certain shrinkage of 25 to 35 percent in the purchasing value of the principal and income of their bonds, in common with bondholders generally.

If this legislation was necessary to avoid universal repudiation of municipal debts, it might be excusable but the testimony at the hearings did not develop the fact that municipal corporations generally are on the verge of repudiating their obligations. True, about 1,000 cities and other political subdivisions are in default but the aggregate amount of their obligations represent only a small part of the total amount, which is estimated to be about $20,000,000,000. Only a

few cities expressed an interest in this bill when a questionnaire was submitted to 189 cities in the country with a population of 50,000 or over. It was testified at the hearings that only 12 of them had responded to the questionnaire. (See p. 30 of the hearings.)

The cities that are in default fall largely into two general classes. First, those overdeveloped by boom conditions and hopelessly involved, such as the Florida cities. Second, those because of unusual tax delinquencies due solely to the prolonged depression, which, while unable to meet their maturing obligations, are still capable of paying interest.

For the first class there is apparently no hope that they can work themselves out of their difficulties without State aid of some kind. For the second class it is reasonable to believe that with any appreciable pick up in general business there will be a substantial reduction in tax delinquencies to such an extent that these cities will soon be able to take care of their obligations. There is really, therefore, no compelling reason to treat this proposed legislation as an emergency matter.

Many communities are now heroically striving to reduce their budgets so that they can meet their obligations as they come due. If this bill passes, it is natural to expect that the incentive to continue doing this will be considerably lessened in many communities. It is not at all unlikely that a growing demand will come from taxpayers to have the authorities avail themselves of the benefits of this easy way out of their financial difficulties rather than by the hard way of continued retrenchment and sacrifice.

It may be well also in this connection to consider the remote as well as the nearer consequences of this bill. If municipal governments may, through the medium of bankruptcy, settle their debts at a discount for so many cents on the dollar on the plea that they have reached the limit of their taxing power, why may not States do likewise; and if State governments, why not the National Government. Of course, if our own governmental debts can be so conveniently reduced why will it not be pointed to as a precedent for a similar treatment of intergovernmental debts.

We ought to stand firm on the principle that a government promise to pay is worth at all times 100 cents on the dollar and that this principle applies with equal force to municipal, State, and National Governments. That has been the principle upon which loans to governments in the past have been predicated and for that reason government securities have been the premier investments on the market. We cannot believe that the same faith and credit will be given to the obligations of municipal corporations in the future if this bill is passed, and, therefore, we feel that on the ground of policy as well as legality it ought to be rejected.

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